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Central Intelligence Agency
Office of the Deputy Director for Intelligence

7 November 1988

NOTE TO: Deputy Director of Central Intelligence

Attached is a short paper responding to Colin Powell's question about Soviet credit lines. I have also attached a copy of the longer memo that discusses Soviet dependence on imports from the West.

I assume you want to send these to Powell with a covering note. However, we can send these out if you wish.

STAT

Richard J. Kerr
Deputy Director for Intelligence

Attachments
A. Soviet Union Credit Lines
B. SOV M 88-20082, dtd Nov 1988

DCI EXEC REG

C-112-15

7 November 1988

MEMORANDUM FOR THE RECORD

SUBJECT: New Credit Lines to the Soviet Union

1. In recent months Western banks have offered the USSR credit lines worth nearly $9 billion [redacted]. The bulk of the lines are to be tied to Soviet purchases of machinery and equipment for the production of consumer goods--not the direct import of consumer goods. Terms for the credits are sketchy at best since negotiations have not been completed--or even begun in earnest--for many of the lines. To date, only the [redacted] lines have been signed. With the credits linked to projects, the payback periods reportedly will be lengthy--up to 8 1/2 years for purchases of plants. Interest rates will be determined at the time contracts are finalized. [redacted] 25X1 25X6 25X1

2. Responding to recent demarches from the USG, the governments of those banks involved in negotiations offered assurances that there would be no subsidization of the credits and that OECD consensus guidelines would be followed. Government backing reportedly will be provided for the [redacted] lines, and possibly for others as the deals progress. This backing or "pure cover" is an agreement by the governments to insure domestic suppliers against the political and economic risks of exporting to the Soviet Union and does not involve direct credits, refinancing, or interest subsidies. [redacted] 25X6 25X1

3. Despite the flurry of activity, there is little evidence to suggest that the USSR will make rapid use of these credit lines. Moscow would have little trouble repaying loans of this magnitude because of its healthy reserves of gold and liquid assets as well as potential export earnings, but the Soviet leadership continues to profess its aversion to a debt run-up to finance imports. Even a modest drawdown of these new credits would have a beneficial impact on the quantity and quality of Soviet consumer goods, albeit probably not for at least several years because of the time needed to bring the imported equipment on line. Moscow currently imports annually about $280 million per year of Western equipment for its food processing and light industries. A tripling of such purchases--consistent with the size of the credit lines--would increase total machinery investment in these industries by about 10 percent. The imports would afford the Soviet capabilities that their domestic industry cannot effectively provide--sophisticated leather tanning, textile finishing, and wool

SUBJECT: New Credit Lines to the Soviet Union

processing equipment for production of clothing and shoes and equipment for processing and packaging fresh and frozen foods. 25X1

4. The impact of the credits on other Soviet economic sectors is harder to gauge. Increased imports of western machinery would reduce at least slightly pressure for the Soviets to reallocate domestically produced machinery toward expanding production capacity for food and consumer goods. Soviet defense industry likely would be one of the beneficiaries, inasmuch as it is now being pressured to use its own resources to increase production of such machinery. The impact on defense, nonetheless, likely would be small.

- -- On the one hand, the credits are not large enough to enable defense industry or any other sector to escape its obligations to the consumer program. Between now and 1995 the Soviets probably will invest the equivalent of about $80 billion in consumer and light industries. The credits will help, but most of the machinery will come from domestic resources and imports from Eastern Europe.

- -- On the other hand, in the absence of the credits it is unlikely that defense would be tasked to make up the entire difference. The Soviets might not modernize the light and food industries on such a scale in the absence of the credits, and non-defense sectors--singled out for wasting investment--likely would share the increased burden. In the extreme, defense industry might be forced to use its own resources to increase annual investment in light and food industries by the equivalent of about $500 million per year, a very small share of total defense industrial output.

Finally, some of the domestic investment resources saved through using the credits would have to be devoted to ensuring that the Soviets would have the wherewithal to repay the credits. The Soviets are likely to continue to have to rely on exports of fuels--particularly oil--for the bulk of their hard currency earnings. Just maintaining current oil export capability will cost the Soviets the equivalent of tens of billions of dollars between now and 1995. The costs of increasing this capability to service new debt probably will continue to make the Soviets take a cautious approach in drawing down the new credit lines. 25X1

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DIRECTORATE OF INTELLIGENCE

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SOVIET DEPENDENCE ON IMPORTS FROM THE WEST: WHY THE NUMBERS BELIE THE RHETORIC

Moscow's much publicized concern over the need to rapidly modernize the economy and, more recently, to address consumer discontent has led many Western observers to assume that Gorbachev will have to turn to the West in a major way for economic and financial assistance. The recent spate of credit lines linked to imports of consumer goods have served to reinforce this theory. In reality, however, the Soviet Union has reduced its imports of Western capital and consumer goods and reduced the growth of real borrowing since Gorbachev came to power. Soviet preference for an indigenous solution to its problems and longstanding concern over becoming vulnerable to Western economic and financial sanctions, in fact, argues for a much more measured turn to the West.

This memorandum was prepared by the Economic Performance Division, Office of Soviet Analysis. Comments and questions are welcome and can be directed to Chief, Economic Performance Division, 25X1

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Perceptions and Reality

There has been substantial discussion both inside and outside the Soviet Union regarding Moscow's need for substantial imports of Western equipment, technology, and consumer products. Debates initially focused on the role of Western technology and equipment in Gorbachev's economic modernization program. They have subsequently broadened to include those consumer goods and services necessary to legitimatize Gorbachev's regime--and his program of *perestroyka*--among rank-and-file Soviets.

In Western circles, such discussions are often a critical element in the larger debate over the appropriateness of "helping" Gorbachev solve his domestic economic problems. Although there may be wide disagreement over what the West should or should not do in this regard, there seems to be a consensus within political and media circles that (a) Moscow will rely heavily on the West and that (b) the Alliance should take steps to ensure that it does not inadvertently provide Moscow with substantial economic and military dividends by competing for Soviet business.

Gorbachev and his economic brain trust have not discouraged Western perceptions of a Soviet need for massive inflows of Western equipment, technology, and consumer products. Economic imperatives aside, it serves Moscow's broader national security objectives to have Western governments "vested" in a positive outcome of the regime's economic and political reform efforts. Discussions of major "joint-venture" arrangements with Western firms contain elements of such vesting. This tactic seems most evident, however, in Moscow's recent successes in landing the official blessings of West European governments for the extension of large credit lines to underwrite Soviet purchases of equipment in support of domestic efforts to improve consumer welfare.

Western expectations of increased Soviet economic dependence, however, contrast sharply with actual Soviet behavior: trade and financial data demonstrate that, if anything, Moscow has become more autarchic under Gorbachev:

- Once one discounts for exchange rate movements, net indebtedness has risen by only 16 percent since 1985; net real borrowing actually fell by $1.5 billion last year.

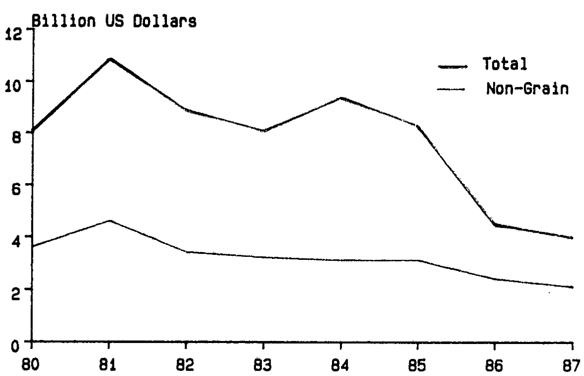
- Soviet imports of Western capital goods have fallen in real terms since Gorbachev came to power; although attention has recently been given to establishing credit lines to underwrite future imports, there are no signs of a substantial upswing in actual orders. The 1989 Soviet Economic Plan, for its part, calls for a slight fall in total trade turnover.

- The leadership cut back substantially on imports of consumer goods in response to falling export earnings, and imports have yet to return to pre-1985 levels despite the increased saliency of improved consumer welfare to the success of *perestroyka*. Austrian companies, for example,

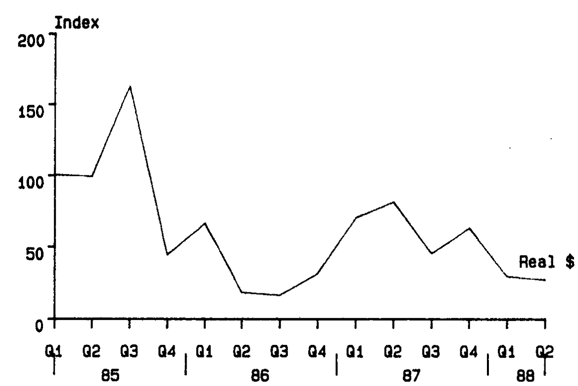
SOVIET CONSERVATISM IS SEEN IN THE DECISIONS TO...

reduce imports, ...

Hard Currency Imports of Consumer Goods, 1980-87

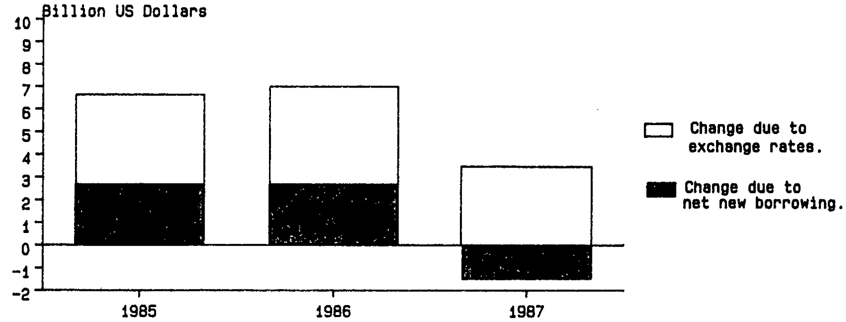


Orders of Western Machinery and Equipment 1985-88



...rather than increase debt.

Estimated Change in Gross Debt



complain that sales of shoes and clothes to the Soviet Union--more than $100 million in 1984--have almost evaporated.

Understanding Soviet Behavior: Past Lessons...

Moscow's reluctance to turn to the West for help is better understood when one considers the nature of economic problems facing the Soviet leadership and the broader implications of economic integration for Soviet national security objectives.

The leadership has undoubtedly drawn a number of sharp lessons from Brezhnev's experience in the mid-to-late 1970s:

-The emphasis on Western technology and equipment as a means of stimulating and leading economic modernization did not live up to its advance billing. While certain sectors--petrochemicals, automobiles--benefited from Western assistance, the overall record reveals a pattern of equipment and technology purchases which were either inappropriate to begin with, never properly installed or--even in the best of circumstances--utilized effectively.

-Expanded trade with the West paid political dividends by engendering potentially divisive competition within the Alliance for Soviet business, both in terms of heavily subsidized credits and pressures to relax COCOM guidelines. At the same time, the subsequent application of economic sanctions to modify Soviet domestic and foreign policy initiatives made the cost of economic dependency abundantly clear to Brezhnev and his successors.

The leadership has paid close attention to the economic and political problems faced by those East European countries that were unable to make good on the gamble of using Western equipment and technology to jack up economic performance to a higher plane:

-While some improvements occurred, the East European experience demonstrated that the sought-after technological and economic gains simply could not be achieved within an economic environment characterized by central plans and administrative economic decisionmaking.

-The price for this failure --economic austerity at home and a pronounced dependency on the goodwill of Western lenders--is still being paid. In some cases, it is at the heart of political dissatisfaction within Eastern Europe.

-Soviet concern with avoiding similar mistakes is captured in a recent interview by the Soviet minister of Light Industry, who stated that Moscow had decided "categorically" against instant gratification. *"That path has no future in it...and the Soviet Union will never be able to get out of [such a] dependence on buying."*

... and Current Realities

Gorbachev's economic advisers also recognize the potential gains from increased use of Western technology and equipment, but they lack the confidence in the ability of the economy--as currently configured--to effectively absorb and ultimately diffuse imported technology on a large scale. They are specifically sensitive to the incongruence between the present set of administrative rules and incentives currently governing enterprise performance and the competitive economic environment--price flexibility, decentralized decisionmaking, competition for sales--needed if the USSR is to effectively draw on Western technology and equipment:

-Firms currently lack the ability to bid for domestic resources or otherwise elicit timely domestic machine builder response to their particular requirements. As a result, enterprises have a distinct bias toward imported equipment --which can be tailored to individual specifications and delivered on a timely basis--even when the same or similar equipment is produced domestically.

-Firms currently are not held fully accountable for the effectiveness of their import decisions. In the absence of an incentive structure to reward proper choices and effective absorption or, conversely, to penalize those who pay little attention to what is purchased and how and when it is installed, there is little guarantee that scarce foreign exchange will be well spent.

Steps have been taken to facilitate direct contacts between Soviet enterprises and Western equipment suppliers and to properly reward effective decisionmaking. *At present, however, Soviet enterprise managers are faced with the worst of all worlds: the old rules governing the selection and purchase of imported equipment have been remanded for many enterprises and ministries, but Moscow has yet to fully develop the sets of procedures to take their place.* This confusion, combined with the uncertainties regarding the implications of imported equipment for self-financing, product pricing, and the generation of hard currency export earnings, may well have resulted in an aggregate decline in enterprise demand for imported equipment. While some of this decline is entirely appropriate for the reasons cited above, enterprise confusion has probably resulted in a suboptimal level of equipment imports over the near term.

Import demand is also constrained by Soviet financial conservatism. This leadership, like those before it, is sensitive to the national security implications of becoming financially overextended. A number of leading Soviets have been particularly explicit on the need to avoid any semblance of dependence on Western financial markets to meet domestic economic imperatives. Any Soviets who doubt the rationale behind this line of argument need only look at the experience of Eastern Europe, the past imposition of economic sanctions, and the persistence of those who seek to monitor and condition credit flows. *This conservatism--manifest in a low level of indebtedness, a substantial "strategic reserve" of gold, and a high level of liquid asset holdings in Western banks--argues against a rapid rise in borrowing unless the ability to repay this debt is fully guaranteed.*

In this regard, the situation facing Moscow in 1988 is far different from the USSR's position in the early-to-mid 1970s, when the Soviets allowed their debt to the West to increase substantially:

-Brezhnev's economic advisers were confident of the Soviet ability to repay a significantly higher level of debt with higher priced oil and other natural resources. In 1988, in contrast, Moscow must contend with stable or declining oil prices and uncertainties over the quantity of oil which will be available for export. The leadership is painfully aware, moreover, that substantial hard currency sales of manufactured goods are not in the cards for the foreseeable future.

-Much of the debt runup in the 1970s was formally tied to Western agreements to purchase Soviet raw materials, notably Siberian natural gas, coal, and wood products. In all cases, the flow of hard currency earnings far exceeded project-associated hard currency expenditures, guaranteeing the Soviets an increase in hard currency import capacity. Although similar deals cannot be ruled out in the 1990s, there are few indications that this option is being heavily pushed.

On the other side of the ledger, Western capital markets are far more developed and the Soviets more sophisticated in tapping them. Initiatives such as bond issues allow Moscow to expand its borrowing before running up against portfolio constraints and otherwise reducing access to additional funds and/or raising the cost of future borrowing. Soviet pragmatists would contend, however, that current conditions only serve to allow Moscow to get into bigger trouble faster.

Gorbachev's Current Initiatives

Soviet emphasis on concluding joint ventures with Western firms reflects these concerns and limitations. The deals, by forcing long-term Western involvement in enterprise decisionmaking and productive efficiency:

-Improve the likelihood for effective Soviet absorption of Western equipment and know-how.

-Increase the chances for increased manufactured goods exports to the Developed West.

-Minimize the drain on scarce hard currency by virtue of Western capital participation and agreements to repatriate profits in the form of products.

The saliency of joint ventures to the leadership's economic agenda is seen in the regime's willingness to bend or change the rules in order to attract Western investors to priority projects. Alternatively, their inability to resolve issues pertinent to the joint venture's access to raw materials and intermediate products and the ability to develop a pricing strategy, hire and fire employees, and repatriate profits in dollars highlights the economic barriers to economywide modernization using foreign investment.

Soviet interest in international organizations such as GATT and the IMF has strong political overtones in signaling Soviet intentions to become a full member of the international economic and financial community. From an economic perspective, links with these organizations would improve foreign trade and financing decisionmaking and otherwise provide the framework for expanded exports of manufactured goods over the long term:

-Moscow is probably most interested in becoming a party to GATT rules and negotiations. Moscow's cooperation agreement with the European Community also reflects the desire to develop a better understanding of potential export opportunities.

-Discussions with the IMF and the World Bank are far more exploratory in nature. More than likely, the USSR is interested in developing a detailed appreciation of the costs and benefits of membership before making any formal approaches: there is no financial need to link up with the IMF at this time.

Beyond joint ventures and a new interest in international trade and financial organizations, however, Moscow's turn to the West is more show than go. By all indications, there is no leadership consensus supporting a major turn to the West at this time. Emphasis continues to be placed on domestic solutions in the belief that substantial increases in the quality and quantity of civilian products--both producer durables and consumer goods--will evolve from the implementation of ongoing programs to:

-Draw on the expertise and productive base of the defense sector.

-Reduce the barriers to the effective development and application of Soviet-designed production and process technologies.

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-Decentralize enterprise decisionmaking and otherwise allow for increased enterprise control over the quality and quantity of inputs it receives.

-Alter the structure of incentives to better reward efficient enterprises and productive employees.

-Increase the supply of consumer goods and services by allowing for greater privatization of economic activity.

Its own reservations regarding the utility of relying more on imports notwithstanding, Moscow has not belittled the belief among Western governments that Western support for perestroyka *can be a profitable business.* In a move somewhat reminiscent of the mid-1970s, Soviet negotiators are concluding a number of major credit agreements with Western bank consortia, explicitly blessed by West European governments, to underwrite future Soviet purchases of Western technology and equipment for the USSR consumer goods sector.

Credit Lines Extended to the USSR

	Secured: April 1974-March 1976 $Millions	Currently Signed or Under Negotiation $Millions
Austria	$ 304	—
Canada	$ 487	$ 500
France	$ 3,095	$ 1,900
Italy	$ 1,917	$ 775
Japan	$ 1,648	$ 2,000
UK	$ 2,270	$ 1,700
FRG	$ 1,334	$ 1,700

While Moscow could well be lining up credit lines now to permit more flexibility in resource allocation decisions pertinent to the next five-year plan, the spate of activity, size of the lines, and their explicit and highly publicized link to improving consumer welfare indicate the presence of a political agenda as well:

-There is no indication that Moscow is prepared to move quickly to place equipment orders against these credit lines.

-Unlike the credit lines of the mid-1970s, when credit competition among Western governments led to substantial interest rate subsidies, the recently concluded lines do not offer preferential financing (outside of

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the slight interest rate savings from the presence of government political and economic risk guarantees) or otherwise materially broaden the potential base for Soviet borrowing.

The Soviet initiative comes at a time of Congressional and Executive Branch consideration of the propriety of restricting or monitoring credit flows to the USSR. Within this context, Moscow--in lining up large credit lines backed by Western political leaders--may have sought to steal a march on any attempt by the US to develop an Alliance-wide consensus on the credit issue. More broadly, Moscow undoubtedly sought to use the credit issue to promote official Western support to Gorbachev's program of economic and social revitalization to the betterment of its larger foreign policy and national security objectives.

And the Road Not Taken

Gorbachev may ultimately be forced to turn to the West for help in transposing the Soviet economy and may buy time in the interim with substantial inflows of consumer goods. Such a decision would quickly become evident to Western analysts by virtue of the media attention to the signing of specific contracts and the like. This option, however, holds dangers that Gorbachev's predecessors did not have to face, making the choice much harder this time around. In many ways it would be a clear sign of leadership desperation:

-Unlike the situation in 1970s, there is no guarantee that Moscow will be able to repay a marked increase in hard currency indebtedness. Barring export increases, the USSR would have to continually increase the level of annual borrowings if it were to maintain a flow of imported goods while servicing an ever-growing debt. It would be only a matter of years before the Soviet leadership would find itself potentially vulnerable to Western economic and political leverage.

-Western firms will want a significantly greater managerial involvement and Western physical presence within the Soviet Union as part of any agreements which meet Gorbachev's demands for Western technology and managerial know-how.

-Unlike the 1970s--when the Soviet leadership viewed expanded trade as a means of complementing a basically sound economic structure--turning to the West this time around will be perceived as a sign that the regime is incapable of fixing its economic problems on its own.